Behaviour v structure: Tribunal's *AGL Energy* merger authorisation

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Introduction

Section 95AT of the *Competition and Consumer Act 2010* (Cth) (CCA) provides that the Tribunal may grant an authorisation to acquire shares or assets that would otherwise contravene s 50. Section 95AT was inserted by the *Trade Practices Legislation Amendment Act 2006* (Cth) and commenced on 1 January 2007. In *Application for Authorisation of Macquarie Generation by AGL Energy Limited*,[1] (*AGL Energy*) the Tribunal has for the first time granted AGL Energy Limited (AGL) a conditional authorisation to acquire the assets of Macquarie Generation from the NSW Government.

Prior to *AGL Energy*, there had been little use made of the authorisation procedure. In 2013, Murray Goulburn Co-operative Co Limited applied to the Tribunal for authorisation of its proposed acquisition of the Warrnambool Cheese & Butter Factory Company Holdings Limited (WCBF) (*Murray Goulburn*). There were competing bids for WCBF and the Tribunal application was subsequently withdrawn in January 2014. Murray Goulburn's application claimed that the merger would generate substantial public benefits in the form of efficiency gains and increased international competitiveness with likely follow-on benefits to farmers and rural communities. Murray Goulburn argued that there would be no substantial detriments. Within two weeks of receiving Murray Goulburn's application, the Tribunal had scheduled a hearing for February 2014. If the application had proceeded it is likely that Murray Goulburn would have had a decision within three months.

The *AGL Energy* decision demonstrates that in the case of mergers giving rise to public benefits, merger authorisation by the Tribunal is a realistic alternative to the ACCC's informal merger clearance process.

AGL Energy's application for authorisation followed on from the ACCC's decision, as part of the informal merger clearance process, that the proposed acquisition would be likely to result in a substantial lessening of competition in the market for the retail supply of electricity in NSW. The ACCC was also concerned about the likely competitive impact of the proposed acquisition on wholesale electricity markets in NSW, Victoria and South Australia.[2] On 24 March 2014, AGL made an application to the Tribunal under s 95AT, seeking authorisation for the proposed acquisition, subject to behavioural conditions. On 25 June 2014, the Tribunal granted AGL an authorisation. On 24 July 2014 the ACCC announced that it would not apply for judicial review of the Tribunal's conditional authorisation of AGL's proposed acquisition of Macquarie Generation.

This note will consider the Tribunal's reasons for its decision in *AGL Energy*.

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[1] *Application for Authorisation of Macquarie Generation by AGL Energy Limited* [2014] ACompT 1 (Mansfield J, Mr G F Latta, and Prof D K Round).

[2] *AGL Energy Limited / Macquarie Generation assets* (ACCC Commission assessment dated 4 March 2014). Available at http://registers.accc.gov.au/content/index.phtml/itemId/1147200/fromItemId/751043

Level of Public Benefits

The Tribunal is required to apply a different test to that considered by the ACCC. The ACCC is required to apply the test set out in s 50, namely whether the proposed acquisition is likely to have the effect of substantially lessening competition in a market. The Tribunal is required to apply the test set out in s 95AT(1), namely whether the proposed acquisition would result, or be likely to result, in a benefit to the public that outweighs any anti-competitive detriment.

The Tribunal was required to compare the level of public benefits "with" and "without" the proposed acquisition. As regards the level of public benefits, the Tribunal concluded that "without" the proposed acquisition:

> …the State would, in the short to medium term, hold and operate the Macquarie Assets and that after a period of two or so years it would probably be prepared to sell those assets to a buyer, more probably a small retailer but possibly an independent small generator or a new infrastructure investor, but at a price which would be significantly less than the price presently offered by AGL. That would be a significantly lesser price because the Macquarie Assets would have a shorter natural lifespan (and significantly so having regard to their present working life) and in the meantime it is likely that they would not have had funds expended on them by Macquarie Generation to maintain and to enhance their present levels of reliability and real output.[3]

"With" the proposed acquisition the proceeds of sale of Macquarie Generation of $1 billion would be re-invested in infrastructure projects in NSW. The Tribunal concluded:

> Having regard to the Tribunal's assessment of the "without" scenarios, the Tribunal is satisfied that significant benefits to the public are likely to follow from the Proposed Acquisition by the payment of $1 billion to the Restart NSW Fund and by relieving the State of having to continue to operate the Macquarie Assets and, in the medium term future, of having to endeavour to sell the Macquarie Assets later to an entity other than AGL at a likely lower price. As the Tribunal explains below, it is satisfied that the Proposed Acquisition is unlikely to result in any material detriments to the public. Having regard to this conclusion, and because the Tribunal is satisfied that significant public benefits will arise from the Proposed Acquisition, the Tribunal is satisfied that the Proposed Acquisition should be allowed to occur.[4]

Level of anti-competitive detriment

As part of the authorisation process, the Tribunal directed the ACCC to provide it with a report pursuant to s 95AZEA of the CCA. The ACCC, in its report to the Tribunal, claimed that authorisation would lead to a permanent structural change and a significant step in the consolidation of NSW power market that could not be reversed. The increase in vertical integration was likely to reduce competitive rivalry in the NSW retail electricity market enabling AGL to retain any benefits that were likely to accrue.

The Tribunal disagreed with the ACCC regarding the level of anti-competitive detriment. Vertically integrated suppliers are referred to as "gentailers".The ACCC argued that in a future "with" the merger, AGL, as a gentailer, would be in a much stronger position in the

[3] *Application for Authorisation of Macquarie Generation by AGL Energy Limited* [2014] ACompT 1 at [193].

[4] *Application for Authorisation of Macquarie Generation by AGL Energy Limited* [2014] ACompT 1 at [232]-[233].

retail market because it could reap the advantages of vertical integration, in particular the so-called "natural hedge" provided to a retailer by owning generation assets. Hedge contracts are financial instruments acquired by electricity retailers directly from generators to cover the risk of a sudden fluctuation in the spot price for electricity in the National Electricity Market (NEM). Hedge contracts are purchased up to three years in advance and provide insurance both as to supply and as to price. As a gentailer, AGL would have certainty of supply. The availability of generation capacity relieves the gentailer of the need to go to the hedge market for its entire retail requirements.[5]

The ACCC argued that a future "with" the merger would raise barriers to entry and expansion by second-tier retailers that were not also generators, by reducing the quantity or quality of available hedge contracts. In a future "without" the merger, in which Macquarie was owned by a party other than AGL, this was less likely to occur.

The Tribunal disagreed with the ACCC's assessment:

> While this is tenable as a theory, the facts speak otherwise. Electricity retailing is a dynamic market that is conditioned by ever-changing supply and demand factors. AGL obviously thinks the acquisition of Macquarie Generation will help it compete more effectively in the retail market, and that, given the excess capacity of the Macquarie Generation plants, it will be able profitably to sell hedges to rival retailers. To deny hedges to potential buyers would lower its potential wholesale revenue and deny it a return on its very large financial investment in Macquarie Generation, and gift wholesale electricity market share to its gentailer rivals. As an input, wholesale electricity is as homogeneous a product as could be imagined, and in this physical input sense retailers would be completely indifferent as to where and by whom their electricity is generated. However, the retail market is intensely competitive, as AGL has found out in its Victorian and South Australian operations. In both states it is a gentailer, yet its retail market share has been falling in each state. The evidence, including from certain of AGL's retail rivals who were called to give evidence, quite clearly demonstrates that in Victoria and SA AGL has a track record of supplying large volumes of hedge contracts to its large and small retail rivals, and that it continues to do this despite its falling retail market share in these states.[6]

Behaviour v structure

In past merger cases the courts have largely follow the structuralist "checklist" of factors identified by the Tribunal in the *Re QCMA* case.[7] In *AGL Energy*, the Tribunal emphasised that the competition analysis of mergers needs to focus on the evidence of the actual past behaviour of the acquirer, and its likely future behaviour post-merger, rather than static, structural considerations. The Tribunal stated:

> There is nothing inherently wrong with a market in which three large firms compete vigorously for market share where there are incentives to steal customers away from rivals. *It is behaviour that matters, not structure per se.* It appears to the Tribunal that it has been invited to assume that the "Big

[5] *Application for Authorisation of Macquarie Generation by AGL Energy Limited* [2014] ACompT 1 at [330].

[6] *Application for Authorisation of Macquarie Generation by AGL Energy Limited* [2014] ACompT 1 at [343]-[345].

[7] See *TPC v Ansett Transport Industries (Operations) Pty Ltd* (1978) 32 FLR 305 at 325 (Northrop J); *TPC v Australia Meat Holdings Pty Ltd* (1988) ATPR ¶40-876 at 49,480 (Wilcox J); and *Arnotts Limited v Trade Practices Commission* (1990) 24 FCR 313 at 336 (Lockhart, Wilcox and Gummow JJ) .

> 3" will not constitute a competitive market principally on the basis of their combined market share immediately post-acquisition on an assumption that competition between them would become muted over time. In the opinion of the Tribunal, oligopolies should not be thus prejudged.[8]

Structural factors can be misleading indicators of post-merger market power. Non-structural factors are equally important in assessing the anti-competitive effects of a merger. Non-structural factors such as excess capacity, the sophistication of retail buyers, new sources of potential supply, and the competitive nature of the merging firms may justify mergers in concentrated markets in which behaviour will significantly constrain the market power of the merger entity.

Conclusion

The Tribunal's decision in *AGL Energy* is noteworthy because the Tribunal emphasised that the competition analysis of mergers needs to focus on the evidence of the actual past behaviour of the acquirer, and its likely future behaviour post-merger, rather than static, structural considerations. Section 50(3) of the CCA sets out the matters that the court must take into account in determining whether an acquisition would have, or be likely to have, the effect of substantially lessening competition in a market. The matters specified largely follow the structuralist "checklist" of factors indentified by the Tribunal in the *Re QCMA* case. However, s 50(3)(g) directs attention to "the dynamic characteristics of the market, including growth, innovation and product differentiation". Merger analysis based on existing structure and constraints alone is not appropriate; it is also necessary to consider the post-merger behavioural constraints that are likely to be faced by the merger firm. As Michal Gal observes:

> Whatever the structural indicators chosen by a small economy to indicate post-merger market power, it is crucial that the dynamic factors of the relevant market be analysed to determine the real effects of the merger. Given that many markets in small economies cross illegality thresholds based on market structure considerations alone that are set by them, analysis of non-structural factors that affect the ability of the firms to exercise market power in concentrated markets is crucial to a correct analysis of the effect of the proposed merger.[9]

The three months' time frame for consideration by the Tribunal under the authorisation can be a problem where there are other bidders as the *Murray Goulburn* application demonstrates. However, in the case of a merger giving rise to public benefits, merger authorisation by the Tribunal has been demonstrated to be a realistic alternative to the ACCC's informal merger clearance process.

[8] *Application for Authorisation of Macquarie Generation by AGL Energy Limited* [2014] ACompT 1 at 77 [369] (emphasis added).

[9] Gal M, *Competition Policy for Small Market Economies* (Harvard University Press, Cambridge, Massachusetts, 2003) p 234.